

## **New Fiscal Plan for Puerto Rico**

# Restoring Growth and Prosperity

**As Certified by The Financial Oversight and  
Management Board for Puerto Rico**

June 29, 2018

## PART III: Restoring growth to the Island

A sustainable fiscal and economic turnaround depends entirely on comprehensive structural reforms to the economy of Puerto Rico. Only such reforms can drive growth in the economy, reversing the negative trend growth over the last 10 years and enabling the Island to become a vibrant and productive economy going forward. To reverse the negative economic trends, the Government must pursue reforms in the following areas:

**Human capital and welfare reforms** will improve job creation, workforce participation, and the well-being and self-sufficiency of welfare recipients, , resulting in a cumulative GNP impact of 0.30% by FY2023. The impact is enhanced in the long-term as K-12 education reforms begin adding an additional 0.01% GNP impact per year, resulting in an additional 0.16% uptick by FY2048 that continues growing in outer years (to 0.28% by FY2060).

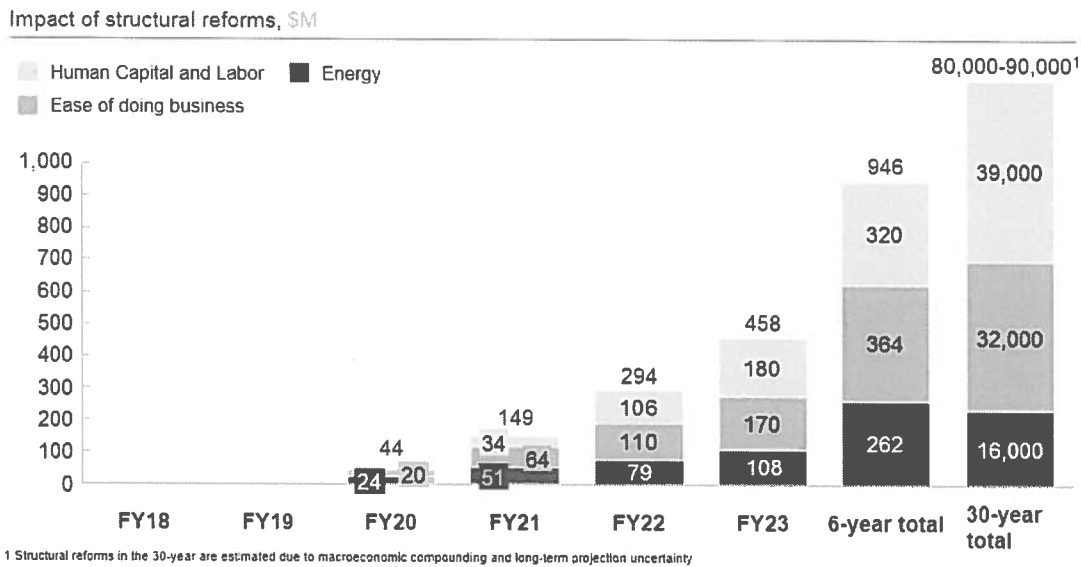
**Ease of doing business reforms** will improve conditions for economic activity and job creation, trading across borders, employment opportunities, and business vitality, resulting in a cumulative GNP impact of 0.65% by FY2023.

**Power sector reforms** will improve availability and affordability of energy for families and businesses, resulting in 0.30% cumulative GNP impact by FY2023.

**Infrastructure reform and capital investment** will improve the flow of goods, services, information, and people across the Island. It has not been scored to provide a specific GNP uptick, yet undoubtedly contributes a consequential uptick in the Island's long-term development.

**If implemented immediately, the structural reforms are projected to result in a sustained 1.25% annual real GNP growth by FY2023.** As shown below (**Exhibit 28**), these reforms equal approximately \$50 billion in increased Commonwealth revenues over 30 years (and over \$100 billion over 40 years). In the long term, **education reforms are projected to add an additional cumulative 0.26% to GNP growth, making total impact 1.41% by FY2048 and 1.51% by FY2058.** The reforms are crucial to placing Puerto Rico on a path to long-term structural sustainability.

## EXHIBIT 28: IMPACT OF STRUCTURAL REFORMS OVER 30 YEARS



## Chapter 7. HUMAN CAPITAL & LABOR REFORM

### 7.1 Current state of human capital and labor and welfare laws

Puerto Rico faces immense challenges with formal labor force participation and preparedness. The Island's formal labor force participation rate is only ~40%, far from the U.S. mainland average (63%) or even the lowest-ranked U.S. state (West Virginia, 53%), and well below other Caribbean islands. In fact, according to World Bank data, Puerto Rico's formal labor force participation rate is currently 7<sup>th</sup> lowest in the world and has never ranked higher than the bottom 20.<sup>32</sup> Puerto Rico's youth unemployment rate is 23.8%, almost double the world average (13.8%) and more than double the U.S. average (10%).<sup>33</sup> Low labor force participation in Puerto Rico is a function of neither Hurricane Maria nor the economic downturn that began in 2006; rather, low rates of employment are a long-term structural problem that can be addressed only through significant changes to public policy.

Unless Puerto Rico substantially increases its labor force participation and employment, incomes will always fall far below mainland states and outmigration will continue to draw Puerto Ricans away from the island of their birth. However, if Puerto Rico improves labor market flexibility through repealing restrictive laws like Law 80 and creating labor conditions more similar to those on the mainland, it will lead to increased labor force participation rates. If Puerto Rico's labor force participation rate grew to match even to that of the lowest U.S. state, incomes would rise, poverty would decline, and the budgetary deficit would improve. **While many other reforms are important to making these improvements, increasing labor force participation may be the single most important reform for long-term economic well-being in Puerto Rico.**

<sup>32</sup> Puerto Rico ranking has never surpassed 215<sup>th</sup> out of the 232 countries, states, and territories tracked by The World Bank Group since The World Bank Group began collecting data in 1990

<sup>33</sup> The World Bank Group, 2017, via International Labour Organization, ILOSTAT database. Data retrieved in March 2017. <https://data.worldbank.org/indicator/SL.UEM.1524.ZS>

### 7.1.1 Labor laws

Puerto Rico's historically low levels of formal labor force participation cannot be attributed to any single factor, but a range of public policies have served to reduce employment on the Island.

Perhaps the biggest barrier to hiring in Puerto Rico is its lack of "at-will employment," which would make it easier for employers to dismiss unsatisfactory employees. While there are variations in labor laws among the 50 mainland states, 49 of them adopt some form of at-will employment. In Puerto Rico, Law 80 was passed in 1976 requiring employers to first prove "just cause" before dismissing employees. Law 80's "just cause" requirement applies to any employees hired for an indeterminate period of time, as well as any employee with a tenure longer than twelve months. In addition, Law 80 mandates significant severance pay: 3 months' base wages, plus two weeks' additional wages for every year of the outgoing employee's tenure. The need to establish just cause can be costly for employers because it typically leads to litigation, and many employers simply pay severance pay to an unsatisfactory employee to avoid a court dispute. Labor flexibility-reducing legislation like Law 80 can also have the additional effect of skewing investment to capital rather than labor, reducing the positive impact of any surplus on the labor market.

While some employees benefit from Puerto Rico's lack of at-will employment, this policy makes it more costly and risky not only to dismiss, but also to hire, an employee. There is evidence that such job protections lower employment opportunities. For example, studies have found that laws preventing unfair dismissal caused reductions in employment, particularly in labor-intensive industries;<sup>34</sup> and in U.S. states, a recent study found that expanding unfair dismissal protections caused employers to shift away from using less-skilled workers and toward greater use of capital investments and more-skilled labor. When Colombia reduced the cost of dismissing workers, unemployment fell and the size of the informal labor force declined.<sup>35</sup> In a 2003 book on labor laws in Latin America and the Caribbean, Nobel Prize-winning economist James Heckman concluded that

*"mandated benefits reduce employment and... job security regulations have a substantial impact on the distribution of employment and on turnover rates. The most adverse impact of regulation is on youth, marginal workers, and unskilled workers. Insiders and entrenched workers gain from regulation but outsiders suffer. As a consequence, job security regulations promote inequality among demographic groups."*

The Government has recently made strides to improve labor market conditions with the Labor and Flexibility Act (Act 4-2017) in January 2017, which added flexibility to overtime regulations and increased work requirements to become eligible for Christmas Bonus and severance pay, among other reforms. However, the Island still is not an employment at-will jurisdiction, imposing costs and regulatory burdens that reduce employment, wages and economic opportunity.

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<sup>34</sup> RAND Corporation, 1992

<sup>35</sup> Kugler (2004). See Dertouzos, James N., and Lynn A. Karoly. "Labor market responses to employer liability." Rand Corporation, 1992; Autor, David H., William R. Kerr, and Adriana D. Kugler. "Does Employment Protection Reduce Productivity? Evidence from U.S. States." *The Economic Journal* (2007): F189-F217; Heckman, James. *Law and employment: Lessons from Latin America and the Caribbean*. No. w10129. National Bureau of Economic Research, 2003; Kugler, Adriana D. "The effect of job security regulations on labor market flexibility. Evidence from the Colombian Labor Market Reform." In *Law and Employment: Lessons from Latin America and the Caribbean*, pp. 183-228. University of Chicago Press, 2004